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NO. 910

# Supreme Court of the United States

October Term, 1966

SOUTH TEXAS RICE WAREHOUSE CO., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

**On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit**

## REPLY BRIEF OF PETITIONER

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## REPLY BRIEF OF PETITIONER

We desire to file this brief reply to the respondent's memorandum in opposition because of what we regard as one of the most fundamental questions presented to this Court in recent years. If the many inaccurate statements in the opinions of the two courts below and the memorandum of respondent are taken at their face value and accepted by this Court, then we have small hopes of its granting our petition for a writ of certiorari as this Court would assume that this case involves only a conflict in the evidence that was resolved against the petitioner and therefore the judgments below should be left undisturbed.

However, if this Court will bear with us briefly, we believe we can illustrate that it involves a most fundamental question concerning the extent of the power of the Commissioner of Internal Revenue under section 482 of the Internal Revenue Code. We feel that this Court should express to the world its interpretation and application of that section just as it has so recently and emphatically expressed its views of other sections in *Commissioner v. Brown,* 380 U.S. 563; *Hanover Bank v. Commissioner,* 369 U.S. 672; *Turnbow v. Commissioner,* 368 U.S. 527; *Helvering v. Flaccus Leather Co.,* 313 U.S. 247; *Helvering v. Hammel,* 311 U.S. 504; and *Old Colony Railroad Co. v. Commissioner,* 284 U.S. 552.

This fundamental question is:

> Where reputable, taxpaying citizens of the United States as a result of hard bargaining on both sides agree on a rental of $48,000 a year to be paid by the lessees and their testimony and that of a disinterested, qualified third party is unimpeached that the rental is reasonable, may the Commissioner of Internal Revenue and the Tax Court and the Court of Appeals, without any evidence to the contrary, completely rewrite the trade so carefully made and raise the rental to $78,000 in the face of the uncontradicted testimony of the lessees that they would not have leased the property if the rental had been over $48,000?

We have in Appendix B to our petition (pages 44-55) set out verbatim most of the testimony and evidence bearing on this fundamental question and for the convenience of this Court will repeat part of it here. First, though we would like to set out certain erroneous statements of the courts below that formed the basis of their decisions and then follow them with the real evidence.

The Tax Court said:

> "This partnership was not a sham. It was organized for the business purpose of transferring to the adult children of L. D. and S. M. Clements, the fathers' interests in the rice drying and warehousing operation, while permitting the fathers to retain their ownership interest in the physical properties." (R. 230)

> "There was considerable testimony as to the negotiations which took place between representatives of Enterprises and S. M. Clements and L. D. Clements who were stockholders in Warehouse but not partners in Enterprises. While we do not doubt that the matter was negotiated and the result of the negotiation was the $48,000 figure, the logical inference for the record as a whole is that the negotiation was not an arm's length one but was for the purpose of satisfying the condition that the attorney who had been consulted by the prospective partners had placed as a requirement for the transaction not being questioned taxwise, 'That they could lease the property but * * * would have to pay a reasonable rent.'" (R. 237)

The Court of Appeals accepted those two erroneous statements as a basis of its affirmance. (Petition 30, footnote 8, 32-33)

The Court of Appeals further said (Petition 40):

> "The Court must look at the substance of a witness' testimony as well as his conclusions. The testimony must be weighed along with all other relevant evidence. Here the Tax Court pointed out that the witnesses overlooked several significant factors in reaching their conclusions." (Petition 40)

The Tax Court's statement on this point was:

"In the case of Warehouse, we view the statements of the two partners that the fair market value of the assets of Warehouse were at no time from June 30, 1957, throughout the years there involved, less than $700,000 as in the nature of an admission. These witnesses in no way reconciled their opinion as to a fair rental value of the assets with their testimony as to the fair market value of those assets. This failure to explain two opinions which without such explanation seem inconsistent persuades us to give little weight to the opinion as to rental value of these interested witnesses. The burden is on petitioner to establish a fair rental value for properties of a lesser amount than the $78,000 a year determined by respondent." (R. 237-238)

As to this $700,000 value we will later show that only one witness, S. M. Clements, and not two, gave no particular weight to it.

We will now give the real material evidence on these points.

J. E. Davant testified:

"Q. Now, you were one of the original parties to the formation of the partnership, South Texas Rice Enterprises?

A. That's right.

Q. State whether or not you and Bob Pegram, that's R. Q., Jr., and Eddie Clark, and at that time, Thurmon Clements, came up to see me some time in May, 1957, about the possibility of forming a partnership and leasing this property from the warehouse company.

A. We did.

Q. Do you recall, in substance, what I told you about it?

A. Yes, sir.

Q. What was that?

A. You said that we could lease the property but we would have to pay a reasonable rent.

Q. You then asked me to get up the partnership agreement, did you not?

A. Yes, sir, we employed you to do that for us.

Q. And that partnership agreement has been introduced in evidence and all of you executed a partnership agreement?

A. That's correct." (R. 51)

Q. What did you all do about fixing the rent, Mr. L. D. Clements and S. M. Clements not being in the partnership, how did you come to a figure?

A. We made an offer of $3,000 a month, coming to $36,000 a year. Dick wouldn't hear to it. He wanted fifty thousand dollars cash.

We finally, after, I guess, about an hour of argument or a little longer, arrived at $4,000 a month. We wanted it on a monthly basis. And that was $48,000, and he finally agreed to that.

Q. What was Mr. S. M. Clements' attitude about your thirty thousand and fifty thousand dollars?

A. Mr. S. M. Clements was right along with Mr. Dick Clements. They wanted what they considered a better rental than we had offered them. They didn't want to lease it and wouldn't agree to it until we came up with a forty-eight thousand dollar figure." (R. 53)

"Q. You say you were there about an hour and a half?

A. We were there longer than that, but at least that one thing was discussed for at least an hour and a half." (R. 54)

"Q. All right.

Mr. Davant, if that rent, if they had demanded $78,000, like the government is claiming in this case, as the rent, state whether or not you would have gone into this partnership and rented it for $78,000 a year.

A. No, sir, I wouldn't. But I would like to explain that." (R. 54-55)

"Q. Well, Mr. Davant, if they demanded more than $48,000, and wouldn't have leased it to you for less, would you have leased it for more than $48,000?

A. No, I wouldn't, because that is more than the going price for dryers at that time." (R. 55)

Edward W. Clark, one of the partners in the lessee, testified on direct examination by Mr. Bruce:

"Q. You had that meeting, testified to by Mr. Davant, in my office. Do you recall when you had it and came to an agreement as to what the rental would be?

A. Yes, sir, I recall.

Q. And just tell the Court briefly what happened there and what the attitude of Spence Clements and L. D. Clements and S. M. was and what your attitude was.

A. We proposed a rental of $36,000, which we thought, in my opinion, I thought was adequate rental, three thousand dollars per month, to operate those facilities. It is quite a responsibility as far as ownership; there is a good deal of liability to be considered in operating a warehouse company and drying rice and storing rice, to be liable for the damaging of it. So I thought $36,000 was very reasonable rent for the lessor. And Mr. Dick Clements thought it should be more. I don't know whether it was forty-eight or fifty or fifty-two, or whatever figure it was, but we finally decided, or he made a remark that forty-eight would be all right with him.

And he said, 'Well, boys, I don't think I want any part of it, a partnership. I don't want any part of it. But you all are young. If you go busted or broke, you have a chance to come back. But I am older and I don't want any liabilities from damaging of rice that you boys don't realize could happen to you.'" (R. 105)

"Q. Would you have gone into it and rented that if Mr. Dick Clements held out for higher rent?

A. I don't think so. I might have paid fifty thousand dollars, but that would have been the most I think I would have paid, in my opinion, at that time, and I would have paid less." (R. 106)

Mr. William S. Fly, one of the partners, testified on direct examination by Mr. Bruce:

"Q. Mr. Fly, you have been present during the testimony and have heard the testimony with reference to the formation of South Texas Enterprises partnership and the leasing of these properties from the Warehouse Company. It's been testified that you were at the conference in my office when it was finally agreed, in June, 1957, the first rent would be $48,000?

A. Yes, sir.

Q. Would you tell the Court, briefly—when I say briefly, in the light of what has been testified—as to whether or not what happened there was substantially the same as Mr. Davant and Mr. Clark testified to?" (R. 127-128)

"A. My recollection is substantially the same. My father-in-law, Mr. Dick Clements, did not want to go into it. We argued with him relative to the amount of rental, as Mr. Davant and Mr. Clark said.

Q. State whether or not there was considerable discussion as to what the lease would be.

A. There was considerable discussion and we were putting some pressure pretty good on Mr. Dick to try to get this rent down to where we thought we could make some money.

Q. And you didn't think that was going to endanger your marital relationship with your father-in-law?

A. No. We worked on it pretty hard, but he went along with it finally.

Q. Why did you want to go into this?

A. I wanted the opportunity to make some money." (R. 128-9)

S. M. Clements and L. D. Clements (the latter having died before the trial) were two stockholders in petitioner and he and L. D. Clements were the ones who forced the lessee to pay up to the $48,000 rent. The evidence showed that in 1960, three years after the 1957 lease, petitioner sold the properties to South Texas Water Company for $700,000. Clements testified that in his opinion the $48,000 was a reasonable rent. The following occurred between the Court and Clements:

"Q. Well, now, the Court was also—there is a deed here in evidence, Exhibit 16, which involved, apparently, the sale of this South Texas property at a time in 1960 when, apparently, there was still outstanding a lease, and the Court was looking at the documentary stamp on that, which gives a rough idea of the price; and I just wondered if you had given any consideration to what the sale price might have been back in 1957 of this property when you considered the fifty thousand dollar rental.

A. Well, I don't know that we had thought about the sale price of it back in 1957. But it certainly would be substantially the same as we sold it for when this took place, except for additional improvements that may have been made. I'd say about the same.

Q. You don't know whether you gave any consideration to what the sale price of this property would be had you chosen to sell it instead of leasing it when you took the fifty thousand dollars?

A. There was no consideration of that that I recall at that time." (R. 137-138)

Now on the strength of that one statement by Clements that in considering the rent in 1957 he did not take into

account what the property sold for three years later in 1960, the Tax Court and the Court of Appeals said his testimony was unworthy of belief, the Court of Appeals saying:

> "Here the Tax Court pointed out that the witnesses overlooked several significant factors in reaching their conclusions." (Petition 40)

R. Q. Pegram, Jr., another partner, testified:

> "By Mr. Bruce:
>
> Q. Mr. Pegram, you have heard the witnesses testify about the conference that was had between members of the Rice Enterprises partnership and Dick Clements and Spence Clements and myself up in my office about how this was fixed?
>
> A. Yes, sir.
>
> Q. Were you at that conference?
>
> A. Yes, sir.
>
> Q. What was your thought at that time as to what rent you should pay?
>
> A. I thought thirty-six thousand dollars a year or three thousand dollars a month was entirely adequate and all we could afford to pay.
>
> Q. What was Mr. Dick Clements' attitude?
>
> A. Mr. Dick Clements' attitude was that it should bring at least fifty thousand dollars a year into the corporation.
>
> Q. And you finally agreed on forty-eight thousand dollars?
>
> A. Yes, sir, four thousand dollars a month." (R. 141)
>
> "Q. Mr. Pegram, if the Enterprises could not have gotten this property, this lease, for around forty-eight thousand dollars, state whether or not you would have been willing to go into the lease.
>
> A. I would not. I was hesitant about paying forty-eight thousand dollars.

Q. State whether or not you knew that the partners would be personally liable for that forty-eight thousand dollars if you didn't make any money in the warehouse.

A. I was fully aware of that." (R. 142)

Mr. Marcus W. Mauritz, 55 years of age, entirely independent of all parties interested in this case, a man who spent his whole life in growing and handling rice, testified:

"Q. Now, Mr. Mauritz, have you become personally familiar with the business properties at Rosharon that constitute this South Texas Enterprises rice warehouse and dryer?

A. Yes, sir, I have.

Q. I believe the record shows that they have a silo with a capacity of 65,000 barrels, a quonset warehouse of 36,000 barrels, and a dryer of 36,000 barrels and a warehouse of 137 by 400 feet, with the machinery that goes along with such a warehouse.

Now, Mr. Mauritz, from your experience in the rice business, state whether or not in your opinion the rental of $48,000 that was provided for in this lease effective July 1, 1957, would be a reasonable rental to pay for the rent of this warehouse property.

A. In my opinion it is excessive." (R. 152)

"Q. Mr. Mauritz, then address your attention to Petitioner's Exhibit No. 18, which shows the total receipts of the Warehouse Company. Say, for example, for the end of June, the year ending June 30, 1957, 280,000 barrels; coming down, 264,000 barrels. And the next three years, 265,000 and then 276,000 for the year ended June 30.

Now, I call your attention to the next column and point out that the large amount of volume of rice available or that you processed as shown under column STRF was the South Texas Rice Farms rice.

Now, with that volume of rice going through there, what would be your thought or your opinion from your experience with a dryer putting that amount of rice through as to whether this $48,000 was a reasonable rental or whether it was, as you say, excessive?" (R. 154)

"A. My opinion that it's excessive, from looking at these figures, that the only rice they are sure of getting would be their half of the rice that they are farming on halves, because they do have the control of that. That is not a sufficient amount to justify paying that much rent.

The rest of it is all problematical.

Basing it upon the last or the previous years of drying, even, and if they would get the same percentage of not only their own but their tenants' and their public, in my opinion it is still excessive rent because I do not think 280,000 barrels, for instance, that was dried in 1956 is sufficient of an insurance to pay $48,000 rent for." (R. 156)

* * *

"And, as has been brought out here, the farmer is going to take advantage of whatever he can to get more for his crop. And then he has to take the necessary step to do that. Sometimes there is storage and sometimes there is not. And I do not think $48,000, to my mind, would be any bargain price at all." (R. 157)

We submit that the above unimpeached testimony completely refutes the statements by the two courts below upon which they based their holdings.

The respondent says that this lease was made so as to have petitioner show a loss and thus have a carryback to the prior three years and get refunds on them. The foregoing evidence shows there is no basis for such a statement.

As to the so-called loss of petitioner, we show on pages 21-22 of our petition that this was due to heavy amortization deductions allowed over a five-year period under the Federal agricultural program. Furthermore, we point out on that page 21 that petitioner for the three years June 30, 1958, 1959 and 1960, actually had net cash gains of $39,008.49, $40,253.53 and $40,951.33.

To show the erroneous attitude of the Court of Appeals, we quote the following statement by it:

> "We cannot say that a three-year reallocation of income approved by the elder Clements with a donative intent brought the type of break in continuity of interest or control that would prevent the application of section 482 in this case." (Petition 34)

How could that court base its opinion on that concept of a *three-year* reallocation of income? The record showed that in 1960 petitioner sold its properties to the South Texas Water Company and on the trial of the case in 1964 this lease was still in effect and respondent knows that it is now in 1967 still in effect, the rent having been raised in 1960 to $50,000.

We ask this Court to look frankly at the taxing procedure in this case. The lease was made with a $48,000 rental. Petitioner then filed its tax return for the year ended June 30, 1958, and found it had a loss. It then carried this loss back to June 30, 1955, 1956 and 1957, and got small refunds. A revenue agent then audits the 1957 return and sees that, if he raises the rent to $78,000, there will be no loss, no carryback and no refund. So, he says $78,000 is a reasonable rent. The courts below, with absolutely no evidence from the Government and in the face of petitioner's evidence, hold to the $78,000 figure under section 482.

We ask: Is this a reasonable basis of taxation? Do not the taxpaying citizens of the United States have any right to manage their affairs in a fair and reasonable manner?

How can a judge of the Tax Court, who never saw the properties involved or ran a rice drying business, say merely out of her own head that $48,000 was unreasonably low? We repeat our quotation on page 24 of our petition from *Loesch & Green Const. Co. v. C.I.R.*, 211 F.2d 210, 211:

> "Their testimony was unimpeached and should have been accepted by the Tax Court *in a matter in which it had no knowledge or experience upon which it could exercise independent judgment;* and such evidence cannot be arbitrarily disregarded."

In addition to the foregoing, we still urge, as in point 5, page 7, of our petition, that in view of Article 5.10 of the Texas Business Corporation Act, section 482 may not come into play in this case.

## CONCLUSION

We respectfully submit that it is just as important for this Court to express to the citizen taxpayers its views as to how far the Commissioner of Internal Revenue may and may not go under section 482 as it was to express its views on the questions involved in *Commissioner v. Brown*, 380 U.S. 563.

In addition, if this judgment below is allowed to stand, a tremendous amount of work will be thrown on the corporations involved and the twelve partners that leased the property and the Government.

In the first place, as is shown in *J. E. Davant, et al., v. Commissioner of Internal Revenue,* No. 911 on this Court's present docket, petitioner was dissolved and its properties were sold to South Texas Water Company on August 26, 1960. The lease of these properties is still in effect in this year of 1967 with Water Company as lessor. The whole matter of the reasonableness of the rental for 1960 to date will be litigated again as Water Company is not bound by the judgment in their case.

Further, if this judgment stands, all of the twelve partners of the lessee partnership will under the mitigation sections 1311 to 1314 of the Code have the right to have their 120 income tax returns for the years 1957 through 1966 re-audited with their being given credit for the additional rent deduction from $48,000 ($50,000 beginning in 1960) to $78,000 and, as they are all subject to the increasingly high individual income tax rates, it is entirely possible that the Government will have to refund to them more taxes that it collects from the lessor corporations.

We respectfully pray that this petition for a writ of certiorari be granted.

Respectfully submitted,

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